Europe in the Danger Zone –
Consolidating EMU in Times of Unprecedented Challenges

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'EU à la carte? Is Differentiation the way for more Europe?'

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'Nothing is possible without men, but nothing lasts without institutions.'
Jean Monnet

'*There are many understandable political reasons to delay structural reform, but there are few good economic ones; the cost of delay is simply too high.*'
Mario Draghi

Abstract:
After Brexit, EU national leaders can no longer escape the need to implement structural reforms and improve Eurozone governance. Since the start of the crisis, considerable progress has been made to stabilise EMU, but the current status quo is not an adequate answer to the challenges ahead. As in other domains of European interest, lack of initiative and reform is only fuelling populism. The ECB has contributed greatly to making up for the lack of policy coordination, insufficient structural reforms, and lack of progress in Eurozone economic governance. But its policy impact has been limited by these shortcomings and it has frequently been under fire for having had to take extraordinary measures.

This paper, first, considers the initial flaws of the monetary project and the progress made since an EMU *a minima* was launched in 1999. Second, it examines the measures needed to make the long-term functioning of the euro area sustainable, and analyses the range of issues and choices that policymakers and political leaders need to face to stabilize EMU whilst addressing the often structural lack of competitiveness encountered among Eurozone members. Finally, it formulates recommendations on how to improve the workings of EMU without further postponing action.

Introduction

After the negative outcome of the British referendum on the UK's relation to the European Union (EU), it has become, more than ever, imperative that European leaders address the issue of whether or not to speed up the economic and political integration of the euro area. They can no longer escape the urgent need to implement domestic reforms and improve Eurozone governance. Since the start of the financial and economic crisis in 2008, considerable progress has been made to stabilise the Economic and Monetary Union (EMU) edifice, but the current status quo is not sustainable on the mid- to long term, and therefore not an adequate answer to the challenges ahead. As in other domains of European interest, status quo and lack of initiative only fuel populist EU-bashing and do not provide a shelter against new crises to come.

The European Central Bank (ECB) has made a substantial contribution to making up for the lack of policy coordination and insufficient structural reforms within the EU-19 monetary bloc, and for the lack of progress in terms of Eurozone economic governance. But the impact of its monetary policies has been limited by these shortcomings and it has frequently been under fire for having had to take extraordinary measures extending well beyond its initial brief. In particular, it currently pursues a very expansionary, interventionist policy marked by large-scale capital injection through Quantitative Easing (QE) in the Eurozone economies and Outright Monetary Transactions (OMT) to make purchases of bonds issued by Eurozone member states. Concerned by persistently low inflation, the ECB is considering even looser monetary policy in its endeavour to lift inflation to its target of close to 2 percent from the current price stagnation and turn the current cyclical upturn into permanently higher growth. But it has not been supported by euro area governments.

This paper, first, considers the progress that has been made since an EMU *a minima* was launched in 1999, in order to fully appreciate the extent of what has been achieved despite the flaws of the initial monetary project. It then examines the measures needed to move beyond the current status quo and make the long-term functioning of the euro area sustainable. In so doing, it analyses the range of issues and choices that policymakers and political leaders need to face to stabilize EMU whilst addressing the often structural lack of competitiveness encountered among Eurozone members. To conclude, it formulates simple recommendations based on common sense in order to improve both the workings of EMU and the economic and business climate of the euro area without unnecessarily postponing urgently needed action to better days.

Initially a currency union carried out *a minima*

The euro area has undeniably gone a long way since Economic and Monetary Union (EMU) was launched in 1999. To fully appreciate the extent of what has been achieved since then, it is useful to remind ourselves of the substantial flaws of the initial monetary construction of Europe.

From the outset, the single currency project was launched without solving the fundamental opposition between two radically opposed monetary philosophies:

- A French stance considering the currency as an instrument of macroeconomic policy, in favour of political control, e.g. of having an exchange rate policy, and which regards controlled inflation as acceptable.
- A German stance traumatised by the hyperinflation of the 1920s, advocating monetary stability and a central bank on the model of the Bundesbank independent from political interference.

These profound differences in the respective approach to monetary policy dividing the two main proponents of monetary integration, France and Germany (Uterwedde 2015), led to the construction of a giant with feet of clay, which was completely unprepared to cushion the random shock of the financial crisis when it started in 2008. The architecture of the single currency, as it was designed in Maastricht, was a construction *a minima*, with:

- No political power to lead and represent to euro area;
- No communitarisation of public debts, which had to remain 'sovereign';
- No banking union, hence no *bail out* in case of a bank going bankrupt;
- No *bail out* in case of default by a member state (any mechanism of financial solidarity was prohibited by Art. 123 and 125);
- No exchange rate policy;
- No fiscal / budgetary policy (only a loose, non-binding 'coordination' of economic policies).

In other words, instead of a water-tight construction, the architecture of the euro area resembled a sand castle. The Stability and Growth Pact (SGP), enacted in 1997, whose purpose was to enforce fiscal responsibility so as to meet Germany's concerns, was grossly insufficient to make up for the acute lack of consistency in the edifice. Even the mention of 'growth' was in name only. It was an empty concession to the French partners which remained a dead letter since the Pact had no provision to stimulate growth. This anecdote only marked the beginning of a harsh debate about austerity versus growth, which started in 1991 in Maastricht. Moreover, the Franco-German misunderstanding in Maastricht was also about Politics versus Economics. Germany wanted *politische Union* but was thinking of its economic interests. France wanted *un gouvernement économique* but this was motivated by political considerations (Trouille 2016).

This weak infrastructure reflected Germany's concern for stability as well as its fear to have to resort to a cheque-book diplomacy to rectify any slippage in budget expenditure of 'club-Med' countries, which Germany only reluctantly admitted as members of EMU. French concerns were different. France was keen to regain some of the monetary sovereignty that it had lost against the Deutschmark. Removing the Bundesbank from its high pedestal, and melting down the Deutschmark into a European single currency was the way to regain at least some of the lost monetary control.

Needless to say that none of these expectations materialised. Furthermore, every country made serious mistakes. This lack of discipline worsened the shock wave of the crisis:

- Germany and France were the first ones not to respect the SGP (rules they had designed themselves!)
- Greece falsified its economic data; successive corrupt governments; pay levels not justified by productivity.
- For years, Italy made too little effort to control exponential rise of public debts.
- Spain allowed a disproportioned private debt and a huge housing bubble.
- Portugal neglected its industrial productivity.
- France adopted a consumption-based demand-side policy and was reluctant to undergo largescale reforms of its welfare state.

Substantial progress has been made …

The financial crisis was a random shock which revealed and exposed EMU's structural weakness with unexpected violence. Its effects are still noticeable in Europe today, almost a decade after the collapse of Lehman Brothers. However, considerable progress has been made since the outbreak of the global financial crisis, whose effect has been to strengthen fiscal governance in the euro area:

- Various mechanisms with substantial solidarity funds in case of a random shock have been set up; in particular, the European Stability Mechanism (ESM), which now acts as a permanent source of financial assistance for member states in financial difficulty, with a lending capacity of up to €500bn, is an embryonic fiscal capacity;
- The ECB has adjusted itself to difficult circumstances, showing that it is not a clone of the Bundesbank. For instance, it adopted a much more pro-active stance with an American type QE policy whilst acting in a fully independent way;
- There is now some 'Federal' control on member states' budgetary policies;
- A banking union (so that banks do not have to be bailed out with taxpayers' money) has been set up;
- Germany has gradually accepted the principle of economic governance (but will France accept a great leap towards further integration?);
- The policy environment, as well as policy credibility, has improved;
- In the case of Greece, no debt repayment is required until 2022-23. Right now the problem of Greece is not debt. What is needed is restoring growth, boosting confidence, carrying out reforms, boosting investments;
- With the Banking Union (BU) and the Capital Markets Union (CMU), which is an EU plan to mobilise capital in Europe and channel it to SMEs and infrastructure projects, a deepening of EMU has been operated in these key areas. There are still some issues,

though. There is no Eurozone agreement with regard to deposit guarantees and Germany in particular is opposed to this principle as it fears it would have to pay for others. CMU scope goes beyond the euro area but is short of concrete projects;

- Last but not least, although support for Europe is at an all-time low, support for the euro remains steady: 73% in Germany, 67% in France, and an average 68% in the euro area. This is a big paradox: on the one hand there is great anger with the EU, on the other stable support for the euro.

… But a lot remains to be done

Despite recent achievements, there are still substantial tasks ahead to effectively consolidate EMU, as the current status quo cannot guarantee its long-term sustainability (Pisani-Ferry 2013). The euro area has been in a crisis mode for too long. It still suffers today from low internal demand and an external surplus, essentially in Germany, which fuels structural deflation. Due to the financial crisis and the insufficient response of the euro area to address it, the EU has lost almost a decade of progress, while the rest of the world has moved forward. Hence, there is an urgent need for further qualitative improvements. There are indeed a range of issues and choices that policymakers and political leaders need to face to stabilize EMU whilst addressing the often structural lack of competitiveness encountered among Eurozone members. These issues and policy choices cover important domains:

- The need for **structural reforms**, not only reforms of the labour market, health system, or pension reforms in some member states (France, for instance, urgently needs to carry out domestic reforms which France has consistently avoided for three decades (Lamy 2014; Aghion *et al.*2015)), but also 'second-stage' reforms focusing on boosting growth and productivity and promoting human capital, as these will provide long-term gains. Education and training are critical to productivity and must be a central preoccupation. Investing in human capital is the key ingredient in making growth more inclusive.

- A need for more investment and innovation. Structural reforms are needed to address national barriers, but also investment barriers. There is insufficient investment in the euro area, and it is almost a decade that Europe underinvests. Chronic underinvestment has generated an investment gap and an innovation gap, resulting in a lack of competitiveness. Lack of competitiveness needs to be addressed both through investment and structural reforms. Tackling the investment issue will allow to address the innovation gap and redress competitiveness. High savings and extremely low interest rates are clear indications of these serious gaps in the economy. There are potentially up to 150,000 small and middle-sized enterprises (SMEs) which could potentially benefit from EU investment plans and investment platforms to boost projects in the Single Market.

- The need to adopt a cautious differentiated approach adapted to the diversity of national economies within the euro area. It would be wrong to make one-size-fits-all reforms: there is a need to differentiate and to consider each particular case. Germany and Greece, Portugal and Ireland, Italy and Finland, cannot all be restrained in a similar straightjacket. A differentiated approach here does not mean an 'à la carte' cherry-picking: it reflects a pragmatic approach that takes stock of the diversity of national economies in a euro area that still has some way to go to match the criteria defined by Mundell (1961) for an Optimum Currency Area (OCA). In any event, such approach should remain cautious, in view of the tendency by some member states (currently France, Italy and Spain) to raise spending in the current recovery after having cutting it in the recession. Consolidating in the downswing, then expanding as soon as the recovery is in sight, is like putting the cart before the horse.

- Finally, and most importantly, the need to establish effective transnational governance and policy coordination, particularly between monetary, economic, structural and fiscal policy, in a growth-friendly approach. Too little progress in terms of fiscal policy, and the current status quo, means that the ECB has had to take extraordinary action well beyond what was its initial brief. In some respect what the ECB has had to go through *just because fiscal policy is deadlocked and because structural reforms have not been sufficient* seems Kafkaesque. More than ever Europe needs more structural reforms and appropriate fiscal coordination to support the ECB's efforts.

All the above points are not only fully sensible: they are crucial, and their combined effect is highly desirable to achieve a paramount aim: more growth, through more effectiveness. Growth is the key: despite a favourable economic environment with low oil prices, historically low interest rates, a weaker euro exchange rate and low borrowing costs, recent economic recovery has only brought limited growth in the euro area. One of the recurrent arguments of the LEAVE campaign in the UK Referendum on the EU is the lack of growth and structural reforms on the European mainland. This may have been one of the very few rational arguments used by Brexit advocates in a referendum campaign dominated by false promises and misrepresentations, but this was nonetheless a genuine concern among British voters who traditionally mistrust the Continent.

With regard to the last point concerning transnational governance and policy coordination, these two elements cannot be disentangled. They are worthy of more attention. The economic case for EMU still needs to be made. In EMU's earlier years too many member states forgot that EMU was not just about monetary union, but also about building up an economic union. The Euro area has been successful in establishing a monetary union, now backed up with a banking union. But although the crisis has brought a consensus that economic union is necessary, this remains to be done. The current deadlock, however, is caused by the combination of two taboos: a French taboo with regard to transfers of sovereignty. And a German taboo with regard to establishing a transfer union. Completion of the euro area therefore faces two obstacles: a sovereignty issue combined with an issue of solidarity. Without breaking this deadlock no progress will be possible.

Policy coordination: an absolute must for ECB and broader EMU efficiency

But let us come back to the need for better policy coordination. Monetary policy and other policies go hand in hand. However, there is a lack of policy coordination, which, in recent years, has cost several points of GDP and many jobs. At the most recent Brussels Economic Forum early June 2016, Mario Draghi called unequivocally for broader policy coordination. He rightly pointed out that the ECB's monetary policy is working in isolation, as the only game in town. But the ECB's QE policy (a massive bond purchase plan of €80bn/month until at least March 2017) is a two-edge sword insofar as on the one hand *it is necessary action*, but on the other *it reduces urgency*. The ECB wants euro area countries to stir up growth, but QE has taken the pressure off for politicians to take action. As a result EU rules have to implement often unpopular measures. Although these rules were toughened up during the sovereign debt crisis, the EU Commission has struggled to enforce them against the will of governments reluctant to coordinate their fiscal policies. EU deficit-cutting rules are often stretched, or even breached, by some member states' budget plans. Massive ECB buying of Eurozone government debt has reduced governments' fears of financial market retaliation for bad policies. Coordination mechanisms work less efficiently under reduced market pressure. Political leaders tend to feel that the short-term political cost of engaging into effective structural reforms is too high. Their instinct is often to boost consumption, since the effects are visible to voters more rapidly. Taking unpopular steps to reform labour laws, pension systems, health care, would be greater, longer-lasting benefits, but only years later.

An economic union: a prerequisite for EMU's future

In order for monetary policy to be less alone in economic policy, the euro area needs a fully-fledged economic union with a Eurozone government. Institutions are vital and may contribute to restoring trust in the EU. As Jean Monnet said, '*Nothing is possible without men, but nothing lasts without institutions.*' In this regard, rules are in place which are often constraining, but rules are not enough: too many member states have, too often, played a non-cooperative game. If Eurozone members want a true economic policy, they need to establish strong institutions. This is not an ideological issue but a practical one based on common sense. It is not a call for more Europe either, but a call for more growth and jobs, and for more stability to face new crises. However, such proposals are difficult to implement because they touch the heart of national sovereignty. Progress continues to be made, for instance the Economic and Financial Affairs Council (ECOFIN), meeting on 16-17 June 2016, agreed on an agenda to strengthen banking union with risk reduction and deposit protection, with a clear roadmap to implement these measures. But we are still at the beginning of an economic union. More transnational governance is needed in the EU, but even more so between the member states that share their monetary sovereignty. The need for cohesion and further integration of the euro area generates de facto a two-speed Europe. It also leaves only some limited room for internally differentiated policy. But deepening EMU should not lead to creating new barriers between countries that are inside and outside the euro area. In that respect the EU will need to tread carefully.

An investment union

An investment union would provide a solid backup to an economic union. The EU already has features in place which, articulated together, can provide the backbone for such a union, based on President Juncker's investment plan, on the EIPP and on the EIB.

EC President Juncker's investment plan of €300bn is a move in the right direction as it aims to provide a favourable investment environment. It is not only timely, but also innovative insofar as it moves away from grants and subsidies towards loans and bank guarantees and uses EU budget resources. The European Investment Project Portal (EIPP) brings together investors and borrowers. And furthermore, thanks to the European Investment Bank (EIB), the EU already has its own investment bank.

The importance of trust

The challenge faced by political elites across the euro area is about convincing everyone, not just eurosceptics, of the wisdom of making further steps towards integration. Concrete solutions are needed, but in addition to this Europe needs a vision which should be inclusive, creative, and 'global-local' in order to re-establish confidence in the European project. Ultimately Europe's biggest challenge is to preserve its competitive position on global markets, and this can only be achieved with a vision relying on trust and determination. Losing an election should not be political elites' first and foremost consideration when the country's long-term interest and the wellbeing of citizens is on the balance.

Trust is also a major stake in the euro area when it comes to fiscal risk sharing. Risk sharing has been underdeveloped with regard to sovereign debt. It is only recently, under the aegis of the ECB, that sovereign debt purchases have taken place. Without progress towards a political union, or at least a more integrated euro area, this will remain an obstacle. In this regard, Northern European citizens will need to understand that a bailout is not a gift, but an economic loan.

Mistrust is also an issue between France and Germany, who launched EMU. When France talks with Germany about *economic coordination* in the euro area, Germany has a suspicion: that it is a French trick not to pursue domestic reforms. Mistrust is a real problem. In fact, BOTH domestic reform and European coordination are needed (Trouille and Uterwedde, 2013).

In conclusion

Finally, a number of simple recommendations need to be formulated to improve the workings of EMU without postponing action any longer. At the last Brussels Economic Forum 2016 on 9 June, Mario Draghi made the following statement:

‘*There are many understandable political reasons to delay structural reform, but there are few good economic ones; the cost of delay is simply too high*’.

What this means is that the current status quo is not an answer to the problems that Europe faces today. In this context, the ECB has been stretched, left alone, and severely criticised. The main obstacle to the consolidation of EMU is not economic, but political. The main obstacle to investment is not financing. It is structural. The main obstacle to a qualitative leap forward towards transnational governance is insufficient trust. Europe has all the required ingredients to make out of EMU a global success apart from one: political will. Reforms will have to be implemented. These reforms should be well coordinated, comprehensive, innovative, and ‘society-minded’ ones.

One precondition for public opinions to regain faith in the European project is to show evidence of the EU’s ability to deliver growth and jobs. It will be difficult for the ECB’s non-conventional policies to stretch beyond the stormy waters where it currently sails without experiencing diminishing returns, possibly even perverse downside effects. Eurozone member states have to take the initiative and do their homework. Priority must be given to strategies with emphasis on innovation, R&D, and structural reforms. ECB monetary policy, combined with the Juncker Plan, will continue to help, but it is clear that their combined effect will not be sufficient to make up for a prolonged lack of action on the part of member states. If the EU is to avoid a repeat of the crisis, it must urgently undertake reforms and address the issue of governance. The recent Five Presidents’ Report (Juncker *et al* 2015) conveyed a similar message with its call for a new convergence process among euro area member states to move towards best practices and structural reforms. Real Eurozone governance has to be backed up with:

- A proper budget for the euro area;
- A Eurozone sub-Parliament with specific competence for the euro area;
- A Finance Minister for the euro area, who would also act as the President of the Eurogroup;
- A specific representation of the Euro area at the G20, the IMF and the World Bank;
- Adopting the simple or qualified majority rule depending on the issue concerned.

Measures inherent to EMU should also be backed up by other measures in favour of growth and job creation in the framework of the Single Market (Monti 2010):

- Measures towards the liberalisation of commercial services;
- Measures to make digital markets more European, rather than having to deal with 28 national regulators;
- Measures to Europeanise capital markets;
- Financial measures to help innovative startups (many of which are incubated in EU universities but are underfunded).
  etc.

Some of these reforms could be adopted reasonably promptly, without treaty change, whilst others would require more time and effort as they imply a change in institutional architecture. Will European leaders follow Mario Draghi's advice? Or else, will another crisis of the magnitude of the one unleashed by the collapse of Lehman Brothers be necessary to come to terms with national political deadlock and, at last, generate long-awaited consensus? In a post-Brexit Europe, there is little space for procrastination and a huge need for action.

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